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C O N F I D E N T I A L SECTION 01 OF 02 SARAJEVO 000082

SIPDIS

STATE FOR EUR/SCE AND EEB/IFD
TREASURY FOR OASIA - PETER MAIER

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TAGS: [EFIN](#) [ECON](#) [PGOV](#) [SOCI](#) [IMF](#) [IBRD](#) [BK](#)
SUBJECT: BOSNIA: IMF SECOND TRANCHE ON HOLD

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Classified By: DCM Jonathan Moore for reasons 1.4 (b) and (d)

Summary

1. (C) Bosnia and Herzegovina Federation entity has not yet met conditions for disbursement of the second tranche of the IMF stand-by arrangement, worth roughly USD 135 million. The IMF's local representative stressed in a January 15 statement that the IMF board will not approve disbursement -- either to the Federation or to the Republika Srpska -- until both entities meet all conditions as agreed last year in June and reiterated in November. The Federation Minister of Finance confirmed in a statement the following week that the Federation has not yet met its commitments to pass necessary reforms. Failure to do so puts at risk not only this disbursement, but ten more scheduled over the next three years, along with supporting loans from the World Bank and European Commission. Loss of these funds would eventually force both the Federation and the Republika Srpska to make deep cuts affecting social programs, wages, and public investments, and would further damage the precarious political situation here in the run up to the 2010 elections. End summary.

Reform of Federation Social Benefits Programs Stalled

2. (U) In his January 15 statement, IMF Resident Representative Milan Cuc focused on the Federation's failure to amend past legislation that had created a complex and overly-generous system of unemployment and pension benefits for veterans, demobilized soldiers, war victims, and former Ministry of Defense employees. In the Bosnian government's June 2009 letter of intent to the IMF, the basis of the stand-by arrangement, the Federation committed to pass such amendments by the end of the year. For its part, the Republika Srpska -- according to the IMF statement -- fulfilled its parallel obligation to adopt legislation establishing a property census of veterans and other beneficiary groups, its minimal legislative requirement for the second disbursement of the IMF program. In both the Federation and the RS, establishment of the property census constitutes a first step in moving from a rights-based to a means-based system of social benefits. Cuc's statement acknowledged that another set of essential steps for disbursement of the second tranche had been met by the end of the year: adoption of 2010 budgets by both entities and the BiH State government within agreed deficit parameters. In the case of the State budget, trimmed to a deficit of 4.5 percent of GDP, reaching agreement within parliament before January 1, the start of the new fiscal year, was an unprecedented event.

A New Concern: Squandering the Special Drawing Rights Windfall

13. (SBU) Privately, Cuc raised a separate concern, not foreseen in the stand-by arrangement. The allocation of new Special Drawing Rights to all IMF members in August 2009 boosted BiH's foreign exchange reserves by 140 million SDRs, or approximately USD 220 million. Initially, BiH authorities had indicated that the SDRs would be held in reserve as a fiscal cushion. Soon thereafter, however, without consulting the IMF, the BiH Central Bank exchanged the SDRs for euros and distributed them to the finance ministries of the two entities. Although not explicitly a violation of the stand-by arrangement, this raised concern in the IMF that the Bosnian government was not acting in the spirit of the program. The IMF has now asked the entity governments to clarify how they will use the windfall. The IMF board will not meet, Cuc has said, until the Federation passes the needed laws and until both entities satisfactorily explain their plans on use of the SDRs.

Bevanda: Yes, We Are the Problem

14. (U) Federation Finance Minister Vjekoslav Bevanda acknowledged in a January 20 statement that "the majority of open issues are related to the Federation" and that failure to pass reform of its system of social benefits was the main obstacle to disbursement of the second tranche. He noted that the Federation's 2010 budget counted on regular disbursements of the IMF program, including the Federation's share of the second tranche, worth KM 128 million (USD 93 million). Highlighting the cost of continued failure to pass

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the necessary measures, Bevanda pointed out that in the absence of funds from the IMF, the Federation would have to make equivalent cuts across the board. Meanwhile, the World Bank, whose separate USD 111 million budget support loan is closely tied to the IMF program and is likewise conditioned on reform of the social benefits system, has already been sending signals that its money will be reprogrammed for other uses if the Federation does not meet the conditions by the end of February. Also at risk is a 100 million euro (USD 140 million) budget support program from the European Commission, and -- further down the road -- the remaining ten disbursements of the IMF program, worth a total of USD 1.35 billion.

Comment

15. (C) We expect the IMF to maintain a strict line regarding the Federation's requirement to enact reforms of the social benefits system, as clearly laid out in the letter of intent.

What the Fund will require regarding the Central Bank's disposition of SDRs is less clear, though it seems likely that the entities will be able to talk their way out of that issue. In the meantime, as the electoral year heats up, enacting the needed reforms will be more critical for the economy, but increasingly difficult politically. The consequences of a delay or blockage in disbursement will flow over into this year's pre-election tensions, and will almost certainly be cited by officials in Republika Srpska as proof of the incompetence of the Federation.

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